

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION



In re:) Case No. 04-26426
)
VERUS INVESTMENT MANAGEMENT,) Chapter 7
LLC,)
) Judge Pat E. Morgenstern-Clarren
Debtor.)
) **MEMORANDUM OF OPINION**

Creditor Duke Realty Limited Partnership moves to dismiss this chapter 7 case on the ground that the debtor Verus Investment Management, LLC filed the case solely to limit Duke’s damages for breach of a commercial lease, which in Duke’s view establishes bad faith under 11 U.S.C. § 707(a). The debtor denies that this proves bad faith. (Docket 7, 12). For the reasons stated below, the motion is denied.

JURISDICTION

Jurisdiction exists under 28 U.S.C. § 1334 and General Order No. 84 entered by the United States District Court for the Northern District of Ohio. This is a core proceeding under 28 U.S.C. §§ 157(b)(2)(A) and (O).

THE STIPULATED FACTS¹

On December 13, 2002, Verus entered into a commercial real estate lease that was assigned to Duke Realty Limited Partnership. Verus provided Duke with a \$1.8 million security deposit. There are four years remaining on the lease at a base rent of \$476,496.00 per year.

In late 2004, after suffering significant losses, Verus began efforts to liquidate its business. With the exception of Duke, Verus paid substantially all of its debt before December

¹ The parties submitted the motion on stipulated facts, exhibits, and oral argument. (Docket 23). The chapter 7 trustee filed a short statement that he believes the petition to be an appropriate filing, but did not otherwise participate. (Docket 13).

31, 2004, as disclosed in the schedules. As part of these efforts, Wayne Lingafelter, on behalf of Duke, and David Webb, on behalf of Verus, discussed a possible agreement under which Duke would permit Verus to terminate its lease before the expiration date and, in return, Verus would pay Duke a termination fee. During the course of those discussions, Verus offered Duke approximately one-year's rent as a termination fee and indicated that, if Duke did not accept the offer, Verus would file a chapter 7 petition to limit Duke's claim for lease rejection damages under bankruptcy code § 502(b)(6).² When the parties were unable to reach an agreement, Verus filed its petition.

² Bankruptcy code § 502(b)(6) provides that:

(b) Except as provided in subsections (3)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount except to the extent that –

* * *

(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds–

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of–

(i) the date of the filing of the petition; and

(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

11 U.S.C. § 502(b)(6).

The chapter 7 schedules show about \$1.9 million in assets (most of which consists of the security deposit) and about \$3.7 million in liabilities, all of which is owed to David Webb, the debtor's sole member. Duke is scheduled as a creditor for an unknown amount, as a precaution.

The debtor's only remaining liability of consequence is to Duke and Webb. This really comes down to a dispute over who gets the \$1.8 million security deposit. If the case is dismissed, Duke presumably will apply the security deposit to the unpaid rent. If the case is not dismissed, the security deposit will be used to pay estate claims, including administrative expenses, Duke's damages (as limited by the bankruptcy code), Webb's claims as allowed, and the additional filed claims as allowed.³

ISSUE

Is it lack of good faith for a debtor to file a chapter 7 case for the sole purpose of limiting a landlord's damages under bankruptcy code § 502(b)(6)?

THE POSITIONS OF THE PARTIES

Duke argues that the debtor's petition should be dismissed as a bad faith filing because the debtor filed it solely to limit Duke's damages for breach of contract. It urges this court to adopt the reasoning from two Third Circuit chapter 11 cases, *In re Integrated Telecom* and *In re PPI Enterprises, Inc.*, apply it in the chapter 7 context, and find this to be a bad faith filing. The debtor contends that existing Sixth Circuit law, *In re Zick*, permits the filing and that this court should not expand the grounds for dismissing a chapter 7 case.

³ Three creditors filed claims; two are not disputed (\$1,003.00) and one is disputed (\$3,610.24).

DISCUSSION

Bankruptcy code § 707 governs dismissals of chapter 7 cases. Section 707(b), which can be used only by the United States trustee or the court on its own motion, provides that a consumer case may be dismissed for substantial abuse of the code. Section 707(a), in contrast, can be used by any party in interest, and provides that:

(a) The court may dismiss a case under this chapter only after notice and a hearing and only for cause, including –

- (1) unreasonable delay by the debtor that is prejudicial to creditors;
- (2) nonpayment of any fees and charges required under chapter 123 of title 28; and
- (3) failure of the debtor in a voluntary case to file, within fifteen days or such additional time as the court may allow after the filing of the petition commencing such case, the information required by paragraph (1) of section 521, but only on a motion by the United States trustee.

11 U.S.C. § 707(a).

In addition to the stated grounds for cause, the debtor's lack of good faith constitutes cause to dismiss. *Indus. Ins. Servs., Inc. v. Zick (In re Zick)*, 931 F.2d 1124, 1127 (6th Cir. 1991).⁴ The facts of each case must be carefully examined to determine if cause exists. *Id.* Courts may consider a number of factors, including whether the debtor's manipulations reduced the number of creditors to one and the unfairness of the debtor's use of chapter 7 under the facts

⁴ The creditor in *Zick* moved to dismiss on the grounds of bad faith, while the Sixth Circuit phrased the question as whether the debtor filed in good faith. The Circuit has not made a clear distinction between bad faith and a lack of good faith and it is not necessary to do so here either.

of the case. *Id.* at 1128.⁵ A dismissal for lack of good faith, however:

. . . should be confined carefully and is generally utilized only in those egregious cases that entail concealed or misrepresented assets and/or sources of income, and excessive and continued expenditures, lavish lifestyle, and intention to avoid a large single debt based on conduct akin to fraud, misconduct, or gross negligence.

Id. at 1129.

The party requesting dismissal bears the burden of proof. *See Alt v. United States (In re Alt)*, 305 F.3d 413, 420 (6th Cir. 2002) (the party moving to dismiss a chapter 13 case for cause based on lack of good faith bears the burden of proof); *Sicherman v. Cohara (In re Cohara)*, – B.R. –, 2005 WL 756571 (B.A.P. 6th Cir. 2005) (the debtor as the party requesting dismissal for cause under § 707(a) bears the burden of proof).

The question here is whether this is an “egregious” case requiring dismissal. There are no concealed or misrepresented assets and there are no expenditure or lifestyle issues. Do the facts, then, show an “intention [on the debtor’s part] to avoid a large single debt based on conduct akin to fraud, misconduct, or gross negligence”? The debtor intends to reduce, but not avoid, the Duke debt. There is no evidence that the debt was incurred through fraud, misconduct or gross negligence, such as by the debtor misrepresenting an ability to pay or concealing financial information when it entered into the lease. Instead, the debt was incurred in the ordinary course of the debtor’s business when the debtor determined that it needed office space in which to conduct its business.

⁵ The other two factors approved by the *Zick* court are: (1) whether the debtor failed to adjust his lifestyle or make efforts to repay; and (2) the fact that the debtor filed his case in response to a creditor obtaining an arbitration award. Neither party argues that these factors are relevant here.

Duke argues that the facts are egregious because (1) the debtor manipulated the situation to reduce its creditors to just one; and (2) it is unfair to let the debtor use chapter 7. On the first point, the debtor identified its creditors prepetition and, with the exception of Duke, paid them amounts due. While the debtor included Duke in its list of acknowledged creditors and negotiated with it to try to reach agreement outside of bankruptcy, they could not resolve the issue. This does not show a manipulation to reduce the creditors to one, but rather an inability to settle a dispute with one creditor. On the second point, Duke contends that it is unfair for the debtor to use chapter 7 under these circumstances because Webb will end up sharing in the distribution to unsecured creditors. Although Duke questions the validity of the Webb debt, it is scheduled as debt based on money loaned by Webb to the debtor to conduct its operations. Assuming the trustee agrees with this characterization, Webb and Duke are both unsecured creditors and having two creditors in similar situations share in a distribution is not unfair.⁶ Also, Duke has the opportunity (and the obligation under Ohio law⁷) to mitigate its damages by re-leasing the space. This will permit it to obtain additional funds to compensate for the contractual breach. These facts do not constitute egregious conduct and are not, therefore, grounds to dismiss the case.

Duke urges this court to reach a different result by adopting the analysis used by the Third Circuit in two recent chapter 11 cases: *Solow v. PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003) and *NMSBPCSLDHB, L.P. v. Integrated Telecom Express*,

⁶ Duke questions whether Webb's claims are loans or equity contributions. That issue is not before the court.

⁷ See *Frenchtown Square P'ship v. Lemstone, Inc.*, 791 N.E.2d 417, 422 (Ohio 2003) (holding that a lessor under a commercial duty has a duty to mitigate the damages caused by a lessee's breach of the lease).

Inc. (In re Integrated Telecom Express, Inc.), 384 F.3d 108 (3d Cir. 2004). *PPI* raised a number of issues, the major one of which was whether a landlord whose claim was capped under § 506(b)(6) was impaired for chapter 11 voting purposes because of the cap. After resolving that issue, the Third Circuit briefly discussed whether the bankruptcy court erred in declining to dismiss the case where the debtor filed its case primarily to use the damage cap. The bankruptcy court found that this did not necessarily show bad faith and the circuit affirmed. *PPI Enters.*, 324 F.3d at 211. The Circuit revisited the issue in *Integrated Telecom Express, Inc.*, where it stated that “*PPI* stands for the proposition that an insolvent debtor can file under Chapter 11 in order to maximize the value of its sole asset to satisfy its creditors, while at the same time availing itself of the landlord cap under § 502(b)(6).” *Integrated Telecom*, 384 F.3d at 123. From this, Duke argues that a debtor cannot file under chapter 7 and use the landlord cap unless it shows that it filed for bankruptcy protection to maximize asset value and increase funds available to creditors. There are two reasons why these cases are not controlling or persuasive. First, they are not controlling because the Sixth Circuit cases use a different analysis of the legal issue and this court must follow our circuit’s law. Second, they are not persuasive because it is not at all clear that even the Third Circuit would reach the same result in the chapter 7 context. The *Integrated Telecom* decision relied to a great degree on the purpose of chapter 11, which it noted is to preserve going concern value and maximize the value of the estate. *Id.* at 128-29. Chapter 7 has a different purpose: to maximize and protect the value of the bankruptcy estate for distribution to creditors. *See generally*, 6 Collier on Bankruptcy ¶¶ 700.01-700.05, 15 ed. rev. (2005) (providing an overview of chapter 7).⁸ Therefore, it is unlikely that the Third Circuit’s position

⁸ Chapter 7 also serves the purpose of providing an individual debtor with a fresh start in the form of a discharge of debts.

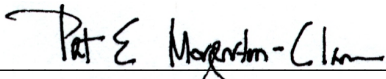
that “[t]o be filed in good faith, a petition must do more than merely invoke some mechanical distribution scheme in the Bankruptcy Code[],” would be applied in the chapter 7 context.

Integrated Telecom, 384 F.3d at 129.

CONCLUSION

For the reasons stated, the motion of Duke Realty Limited Partnership to dismiss is denied. A separate order will be entered reflecting this decision.

Date: 9 May 2005



Pat E. Morgenstern-Clarren
United States Bankruptcy Judge

To be served by clerk’s office email and the Bankruptcy Noticing Center

THIS OPINION NOT INTENDED FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION




In re:) Case No. 04-26426
)
VERUS INVESTMENT MANAGEMENT,) Chapter 7
LLC,)
) Judge Pat E. Morgenstern-Clarren
Debtor.)
) **ORDER**

For the reasons stated in the memorandum of opinion issued this same date, the motion of Duke Realty Limited Partnership to dismiss is denied. (Docket 7).

IT IS SO ORDERED.

Date: 9 May 2005


Pat E. Morgenstern-Clarren
United States Bankruptcy Judge

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